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By PwC Deutschland | 30. August 2024

Foreign currency losses in the case of shareholder loans to subsidiary in third countries not deductible

In a most recent decision, the Supreme Tax Court held that foreign currency losses on shareholder receivables similar to loans do not reduce the taxable income of the corporation. This was decided by the Supreme Tax Court in its interpretation of Section 8b (3) Corporation Tax Act as valid in 2014 and which deals with investments in other corporations and the non-deductibility of losses in connection with certain shareholder loans.

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Background

The parties are in dispute as regards the interpretation of Section 8b (3) Corporation Tax Act (CTA). The tax courts were asked to decide whether foreign currency losses resulting from loans to a foreign subsidiary were deductible or if the loss amount must be added off-balance sheet to taxable income in accordance with Section 8b (3) sentences 4 to 7 CTA.

The plaintiff is a German company. It sold its products abroad partly via subsidiaries and partly via third parties. In Brazil, sales were made via the Brazilian subsidiary B. During a tax audit, it was discovered that the plaintiff had granted B a payment term of 90 days, but that the receivables were regularly only paid seven to nine months after invoicing, while the foreign sales partner in Argentina paid the receivables after an average of 88 days. The delayed payment by the Brazilian subsidiary resulted in currency losses. The tax office disallowed the losses through an off-balance sheet addback to taxable income.

The complaint before the Tax Court of Baden-Württemberg was rejected.

Decision

The Supreme Tax Court agreed with the decision of the lower tax court and dismissed the appeal as unfounded.

Foreign currency (exchange) losses on shareholder receivables **similar to loans** do not reduce the income of the corporation prior to 1 January 2022 (i. e., the date of entry into force of the *Act to Modernize Corporate Income Tax Law*), as they fall within the scope of Section 8b para. 3 sentences 4 and 7 CTA.

According to the applicable Section 8b (3) Sentence 3 Corporation Tax Act (CTA) - as valid in the year of dispute (2014) – “losses in connection with the share named in subsection 2 are to be ignored when computing the taxable income”. Section 8b (3) sentence 4 provides that losses within the meaning of sentence 3 include losses **in connection with a loan**, or from claims on a surety for a loan, where loan or surety were granted by a shareholder who holds or held directly or indirectly more than one-quarter of the ordinary share capital of the borrowing company”.

The Supreme Tax Court confirmed the view held by the court of first instance, namely that – given the specific circumstances in the case of dispute (trade receivables from deliveries and from the provision of services plus exceeding the term of payment of 90 days by at least a further 90 days) - **a claim similar to a loan is affirmative**. The (legal or de facto) extension of the original payment terms was intended to provide liquidity in an economically tense situation in order to secure the financial requirements of the subsidiary; therefore, there was a sufficient purpose and need for a financing.

Since Section 8b (3) sentence 4 expands the scope of application of Section 8b (3) sentence 3 CTA, it also applies not only to shareholdings in domestic companies, but also to shareholdings in foreign companies.

The plaintiff did not meet the requirements for an **exception pursuant to the third-party comparison** in Section 8b (3) sentence 6 CTA which provides that sentences 3 and 4 (the disallowance of the currency

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losses) are not applicable if it can be shown that a third party would have granted the loan, or not yet demanded its repayment in otherwise similar circumstances.

According to the Supreme Tax Court there are basically two ways to prove an arm's length comparison. Either the taxpayer (supplier/creditor) proves that in comparable cases and under comparable conditions it has not collected trade receivables due from third parties and/or has deferred them without interest. Or it can be demonstrated that third parties who were also creditors of the Brazilian subsidiary have agreed or de facto granted corresponding extensions of payment terms in comparable cases. However, this evidence could not be demonstrated by the plaintiff.

This overall conclusion is also **not in violation of current EU law**: Where a third-country case is involved (here: Brazil) and in light of the 100% shareholding of the plaintiff, the freedom movement of capital (Art. 63 para. 1 of the Treaty on the Functioning of the European Union - TFEU) which also applies to transactions with third countries is blocked by the overriding freedom of establishment (Art. 49 TFEU) and hence is not applicable in the case of dispute.

Note: Inthe *Act to Modernize Corporate Income Tax Law* from June 2021 **Section 8b CTA was amended** to the effect that foreign exchange losses incurred after 31 December 2021 by a corporation on a loan receivable or comparable position vis-à-vis another company in which it holds or held an interest of more than 25% do not fall under the non-deductible items mentioned in Sec. 8b (3) Sentence 4 CTA. The same applies to exchange losses incurred by related parties of the shareholder and to exchange losses in connection with so-called third-party recourse.

Source:

Supreme Tax Court, decision of 24 April 2024 (I R 41/20) – published on 29 August 2024.

In another **partly identical judgment** of 24 April 2024 - I R 11/23, the Supreme Tax Court also held that exchange rate losses on foreign currency shareholder loans prior to the entry into force of the Act to Modernize Corporate Income Tax Law do not reduce the income of the corporation granting the loan - subject to review of the applicable EU law.

Schlagwörter

Loss relief, shareholder loan